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Supreme Court of the United States

OCTOBER TERM, 1947

795431

Sup. Ct.

No. 658

THE CANISTER COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE THIRD CIRCUIT

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INDEX

	PAGE
PETITION FOR WRIT OF CERTIORARI	
Summary statement of the matter involved	1
Jurisdictional statement	3
Questions presented	3
Statutes involved	4
Reasons relied on for allowance of the writ	4
Prayer for writ	8
Appendix	9

CITATIONS

Cases:

Brewster Shirt Corp. v. Commissioner, 159 F. 2d 227 (C. C. A. 2, 1947)	6, 7
Butterworth-Judson Corp., United States v., 267 U. S. 387 (1925)	4, 5
Butterworth-Judson Corp., United States v., 297 Fed. 971 (C. C. A. 2, 1924)	4
Claridge Apartments Co. v. Commissioner, 323 U. S. 141 (1944)	7
Consolidated Goldacres Co. v. Commissioner, F. 2d (C. C. A. 10, Dec. 12, 1947)	5, 6, 7
Crane v. Commissioner, 331 U. S. 1 (1947)	7
Dobson v. Commissioner, 320 U. S. 489 (1943)	7
McWilliams v. Commissioner, 331 U. S. 694 (1947)	7
Powder Co. v. Burkhardt, 97 U. S. 110 (1877)	5

(R. 17a; 20a.) Once the advances were made, the petitioner was unilaterally and unconditionally bound as principal and primary obligor to repay the advances under all circumstances.

The advances to the petitioner were made under authority of Act of June 28, 1940¹ and of the First War Powers Act of 1941.² (R. 16a; 19a.) These acts *inter alia* authorized the Secretary of the Navy to make advances to war contractors when such action "would be in the best interests of national defense" or "would facilitate the prosecution of the war," provided "adequate security for the protection of the Government for the payments so made" was furnished by the contractors.

The petitioner treated the Government advances as borrowed capital in computing its excess profits credit on the invested capital basis. (R. 4a.) This could properly be done pursuant to Section 719(a)(1) of the Internal Revenue Code³ if the Government advances created a debtor-creditor relationship between the petitioner and the Government, and if the "outstanding indebtedness" so created was

"evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust
• • •."

The respondent excluded the amount of the Government advances from the petitioner's borrowed capital for its fiscal year 1942, thereby increasing the petitioner's "excess" profits for that year. (R. 4a.) He therefore determined a deficiency in the petitioner's excess profits tax in the amount of \$11,704.38, plus interest. On October 16, 1946 the Tax Court of the United States upheld the respondent's determination. (R. 3a; 7 T. C. 367.) The Tax

¹ Chapter 440, Tit. 1, § 1, 54 Stat. 676, 50 U. S. C. App. 1940 ed., § 1151 (1944), set forth in Appendix, *infra* p. 10.

² Act of December 18, 1941, c. 593, Title II, § 201, 55 Stat. 839, 50 U. S. C. App. 1940 ed., § 611 (1944), set forth in Appendix, *infra* pp. 10-11.

³ 54 Stat. 984 (1940), set forth in Appendix, *infra* p. 9.

Court held that the Government advances were not loans giving rise to "outstanding indebtedness" within the meaning of Section 719(a)(1) of the Code, and that the bonds furnished to the Government by the petitioner to secure the repayment of the advances were not "bonds" within the meaning of that Section.

The Circuit Court of Appeals for the Third Circuit affirmed the decision of the Tax Court on January 20, 1948. (R. 27; not yet officially reported.) The Circuit Court of Appeals treated the issues before it as questions of fact and held that under the decision of this Court in *Commissioner v. Scottish American Investment Co.*, 323 U. S. 119 (1944), it was precluded from reviewing the decision of the Tax Court. In the alternative, the Circuit Court of Appeals held that as a matter of law the advance payment bonds were not "bonds" or other proper evidences of indebtedness within the meaning of Section 719(a)(1) of the Internal Revenue Code.

Jurisdictional Statement

Jurisdiction to review this case upon writ of certiorari is expressly conferred upon this Court by Section 1141(a) of the Internal Revenue Code, 53 Stat. 164, and Section 240(a) of the Judicial Code, as amended (Act of March 3, 1891, c. 517, § 6, 26 Stat. 828; Act of March 3, 1911, c. 231, § 240, 36 Stat. 1157; Act of February 13, 1925, c. 229, § 1, 43 Stat. 938; U. S. C. Title 28, § 347).

Questions Presented

1. Whether advances made by the Government to the petitioner, a war contractor, under authority of the Act of June 28, 1940 and of Section 201 of the First War Powers Act of 1941 are, as a matter of law, loans creating "outstanding indebtedness" within the contemplation of Section 719(a)(1) of the Internal Revenue Code.

2. Whether bonds given by the petitioner to evidence the outstanding indebtedness created by the receipt of Gov-

ernment advances and to secure their repayment are, as a matter of law, "bond[s]" or are otherwise evidences of indebtedness within the contemplation of Section 719(a)(1) of the Internal Revenue Code.

3. Whether the advance payment bonds, when considered together with the contract with the Navy Department, are, as a matter of law, evidences of indebtedness within the contemplation of Section 719(a)(1) of the Internal Revenue Code.

Statutes Involved

The pertinent statutes are set forth in the Appendix, *infra*, pp. 9-11.

Reasons Relied on for Allowance of the Writ

This Court is requested to grant the writ for the following reasons:

1. The Circuit Court of Appeals for the Third Circuit held that advances made by the Government to a war contractor under the provisions of the Act of June 28, 1940 and of Section 201 of the First War Powers Act of 1941 are not loans creating outstanding indebtedness. Its decision is in conflict with the decision of this Court in *United States v. Butterworth-Judson Corp.*, 267 U. S. 387 (1925), and with the decision of the Circuit Court of Appeals for the Second Circuit on this point in the same case (297 Fed. 971). This Court (267 U. S. 387, 392, 393), and the Circuit Court of Appeals for the Second Circuit below (297 Fed. 971, 978), there treated advances under the Urgent Deficiency Act of 1917,⁴ after which the Act of June 28, 1940 was patterned and whose basic policy is extended by the First War Powers Act of 1941, as creating the relationship "of debtor and creditor" between a war contractor and

⁴ Act of October 6, 1917, c. 79, § 5, 40 Stat. 345, 383.

the Government.⁵ Further, this Court, in *Powder Co. v. Burkhardt*, 97 U. S. 110 (1877), affirmed a decision that advances made to facilitate the performance of a contract by a contractor were "as a matter of law" (see 97 U. S. 110, 115) loans creating the relationship of debtor and creditor.⁶ Although the *Butterworth-Judson Corp.* case was a suit by the Government to enforce an equitable lien and the *Powder Co.* case involved an action for wrongful conversion, the legal principle this Court enunciated in those cases should apply where a corporation's tax liability is at issue.

The Government made numerous advances to war contractors under the provisions of the Act of June 28, 1940 and of Section 201 of the First War Powers Act of 1941. As those or similar Acts would probably be in force should another national emergency develop, it is urgent that the nature of such advances be settled by this Court. Not only is this issue of importance to the petitioner, as well as to similarly situated war contractors, but the creditor's rights of the Government (*cf. United States v. Butterworth-Judson Corp., supra*) have been made uncertain, thus inviting litigation which consideration of the instant case by this Court would avert.

2. The Circuit Court of Appeals for the Third Circuit relied upon *Consolidated Goldacres Co. v. Commissioner*,⁷

F. 2d (C. A. A. 10, Dec. 12, 1947), when holding that the advance payment bonds furnished by the petitioner pursuant to the specific provisions of the Navy contract were not "bonds" or other evidences of indebted-

⁵ Advances made under these Acts were in practice treated as loans by the Navy Department. For example, as to advances made after April 10, 1942, an interest charge of 2½% per annum was made "for the use of the Government money so furnished." Navy Procurement Directives, para. 12,231.

⁶ See also *Summit Coal Co.*, 18 B. T. A. 983 (1930), *acq.* IX-2 Cum. Bull. 58 (1930).

⁷ *Consolidated Goldacres Co. v. Commissioner, supra*, held that a "contract of conditional sale" is not an "outstanding indebtedness" evidenced by a "note," "mortgage" or other type of instrument contemplated by Section 719(a)(1) of the Internal Revenue Code.

ness within the meaning of Section 719(a)(1) of the Code. This narrow interpretation does "violence to the language" of the Statute (cf. *Trust of Bingham v. Commissioner*, 325 U. S. 365, 382 (1945) (concurring opinion)), for the bonds securing the Government's advances were a type of bond in general use. In the *Consolidated Goldacres Co.* case the Tenth Circuit admitted that its narrow construction of Section 719(a)(1) is irreconcilable with the more natural interpretation of that Section by the Second Circuit in *Brewster Shirt Corp. v. Commissioner*, 159 F. 2d 227 (C. C. A. 2, 1947). This conflict in statutory interpretation should be resolved by this Court. The conflict makes uncertain both the meaning of Section 719(a)(1) and the meaning of the term "bond" wherever it appears in the Internal Revenue Code.

The Second Circuit determined in *Brewster Shirt Corp. v. Commissioner*, *supra*, that it was not the intention of Congress when it enacted Section 719(a)(1) to subject "persons of only moderate financial strength who cannot obtain the money they need from commercial banks" to "burdensome excess profits taxes" (159 F. 2d at 229). It therefore held that certain factoring agreements and assignments of accounts receivable made in connection therewith were a "mortgage" as "a matter of substance" within the contemplation of Section 719(a)(1) of the Code, even though not a mortgage in form. The spirit of the Second Circuit's decision requires that the secured Government advances here involved likewise be treated as borrowed capital for excess profits tax purposes.

The interpretation of Section 719(a)(1) of the Code by the Third Circuit places a disproportionately heavy tax burden upon those comparatively small companies whom the Government financed during the war through advances, adequately secured, such as were made to the instant petitioner.

3. When originally introduced in Congress as H. R. 10413, the Second Revenue Bill of 1940 defined "borrowed capital" as "outstanding indebtedness * * * of the

taxpayer which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust". This phrasing remained unchanged during the entire course of the Bill's journey through Congress and ultimate enactment. The House Ways and Means Committee, in its report on the Bill, considered the above definition of "borrowed capital" as including in its scope "any other written evidence of indebtedness" in addition to the specifically named instruments.⁸ Section 719(a)(1), so interpreted, clearly encompasses the bonds given by the petitioner to unconditionally secure the repayment of the Government advances. The conditions of the Statute are met whether such bonds are considered alone or in conjunction with the provisions of and limitations in the Navy contract. *Cf. Brewster Shirt Corp. v. Commissioner, supra.*

4. The question whether Government advances made under the provisions of the Act of June 28, 1940 and of Section 201 of the First War Powers Act of 1941 are loans creating outstanding indebtedness "is one of law and of a sort not requiring the specialized experience of the Tax Court to determine." *Cf. Claridge Apartments Co. v. Commissioner*, 323 U. S. 141, 145 (1944) (interpretation of bankruptcy laws). Thus, the determination of the Tax Court and of the Circuit Court of Appeals on this issue is reviewable by this Court. Moreover, the meaning to be given to the term "bond" in Section 719(a)(1) of the Code presents a clear-cut question of law, which this Court may consider upon review. *Crane v. Commissioner*, 331 U. S. 1, 15 (1947); *McWilliams v. Commissioner*, 331 U. S. 694, 703 (1947); *Commissioner v. Wilcox*, 327 U. S. 404, 410 (1946); *Trust of Bingham v. Commissioner*, 325 U. S. 365, 370-371 (1945); *Brewster Shirt Corp. v. Commissioner*, 159 F. 2d 227 (C. C. A. 2, 1947); *Consolidated Gold-acres Co. v. Commissioner*, F. 2d (C. C. A. 10, Dec. 12, 1947); cf. *Dobson v. Commissioner*, 320 U. S. 489, 502

⁸ H. R. Rep. 2894, 76th Cong., 3rd Sess., p. 26, accompanying H. R. 10413 (Union Calendar No. 1071).

(1943); *Commissioner v. Scottish American Investment Co.*, 323 U. S. 119, 123 (1944).

The issues of law in this case are of broad implication. Clarification of when a bond is a "bond" for tax purposes is of importance to the proper administration of the tax laws, for the Internal Revenue Code contains no definitive guide. Moreover, the obligations incurred by contractors who received Government advances to finance and thus facilitate war production, and the creditor's rights of the Government in regard thereto, are indeed matters of wide interest. The decision of the Circuit Court of Appeals below on these issues conflicts with decisions of this Court and of the Circuit Court of Appeals for the Second Circuit. These conflicts should be resolved by this Court upon review.

Prayer for Writ

WHEREFORE, your petitioner respectfully prays that a writ of certiorari be issued out of and under the seal of this Court to the United States Circuit Court of Appeals for the Third Circuit commanding said last named Court to certify and send to this Honorable Court a full and complete transcript of the record of all proceedings in the within cause and to stand to and abide by such order and direction as to your Honors shall seem meet and the circumstances of the case require and that your petitioner may have such other and further relief or remedy in the premises as to this Court may seem proper.

Dated: New York, N. Y., March 4, 1948.

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Appendix

Internal Revenue Code:

SEC. 719 [as added by Sec. 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974].

BORROWED INVESTED CAPITAL.

(a) *Borrowed Capital*.—The borrowed capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following:

(1) The amount of the outstanding indebtedness (not including interest, and not including indebtedness described in section 751 (b) relating to certain exchanges) of the taxpayer which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, plus,

(2) In the case of a taxpayer having a contract (made before the expiration of 30 days after the date of the enactment of the Second Revenue Act of 1940) with a foreign government to furnish articles, materials, or supplies to such foreign government, if such contract provides for advance payment and for repayment by the vendor of any part of such advance payment upon cancellation of the contract by such foreign government, the amount which would be required to be so repaid if cancellation occurred at the beginning of such day, but no amount shall be considered as borrowed capital under this paragraph which has been includible in gross income.

(b) *Borrowed Invested Capital*.—The borrowed invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be an amount equal to 50 per centum of the borrowed capital for such day.

(26 U. S. C. 1940 ed., Sec. 719.)

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Act of June 28, 1940 [Chapter 440, Title 1, § 1, 54 Stat. 676]:

**ADVANCE AND PARTIAL PAYMENTS ON DEFENSE CONTRACTS; LIEN
ON PAYMENTS; REPORT TO CONGRESS**

Whenever in the opinion of the President of the United States such course would be in the best interests of national defense during the national emergency declared by the President on September 8, 1939, to exist, the Secretary of the Navy, or the Secretary of the Treasury in the case of Coast Guard contracts, is authorized to advance, from appropriations available therefor, payments to contractors in amounts not exceeding 30 per centum of the contract price, upon such terms as such Secretary shall prescribe, and adequate security for the protection of the Government for the payments so made shall be required. The Secretary concerned is further authorized in his discretion to make partial payments on the balance of the contract price from time to time during the progress of the work, such partial payments not to exceed the value of the work already done, but to be subject to a lien as provided by the Act of August 22, 1911 (37 Stat. 32; 34 U. S. C., § 582), entitled "An Act authorizing the Secretary of the Navy to make partial payments for work already done under public contracts": *Provided*, That the Secretary concerned shall report every three months to the Congress the advance payments made under the authority of this section.

(50 U. S. C. App. 1940 ed., Sec. 1151.)

• • • • •

First War Powers Act of 1941 [Act of December 18, 1941, c. 593, Title II, § 201, 55 Stat. 839]:

**WAR CONTRACTS EXEMPT FROM CERTAIN RESTRICTIONS UPON
AUTHORIZATION BY PRESIDENT**

The President may authorize any department or agency of the Government exercising functions in connection with the prosecution of the war effort, in accordance with regula-

tions prescribed by the President for the protection of the interests of the Government, to enter into contracts and into amendments or modifications of contracts heretofore or hereafter made and to make advance, progress and other payments thereon, without regard to the provisions of law relating to the making, performance, amendment, or modification of contracts whenever he deems such action would facilitate the prosecution of the war: *Provided*, That nothing herein shall be construed to authorize the use of the cost-plus-a-percentage-of-cost system of contracting: *Provided further*, That nothing herein shall be construed to authorize any contracts in violation of existing law relating to limitation of profits: *Provided further*, That all acts under the authority of this section shall be made a matter of public record under regulations prescribed by the President and when deemed by him not to be incompatible with the public interest.

(50 U. S. C. App. 1940 ed., Sec. 611.)

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute and regulations involved	2
Statement	2
Argument	7
Conclusion	11
Appendix	12

CITATIONS

Cases:

<i>Bazley v. Commissioner</i> , 331 U. S. 737	10
<i>Brewster Shirt Corp. v. Commissioner</i> , 159 F. 2d 227	9, 10
<i>Commissioner v. Estate of Bedford</i> , 325 U. S. 283	10
<i>Commissioner v. Park</i> , 113 F. 2d 352	8
<i>Commissioner v. Scottish American Co.</i> , 323 U. S. 119	8
<i>Consolidated Goldacres Co. v. Commissioner</i> , 165 F. 2d 542	9, 10
<i>Crane v. Commissioner</i> , 331 U. S. 1	10
<i>Deputy v. du Pont</i> , 308 U. S. 488	8
<i>Dobson v. Commissioner</i> , 320 U. S. 489	8, 10
<i>Enright v. United States</i> , 54 F. 2d 182, certiorari denied, 286 U. S. 543	9
<i>Flint Nortown Theatre Co. v. Commissioner</i> , 4 T. C. 536	9
<i>Gilman v. Commissioner</i> , 53 F. 2d 47	8
<i>Gould & Eberhardt, Inc. v. Commissioner</i> , 9 T. C. 455	9
<i>Higgins & Co. v. Commissioner</i> , 4 T. C. 1033	9
<i>Journal Publishing Co. v. Commissioner</i> , 3 T. C. 518	9
<i>Powder Co. v. Burkhardt</i> , 97 U. S. 110	9
<i>United States v. Butterworth-Judson Corp.</i> , 267 U. S. 387	9, 10
<i>United States v. Kirby Lumber Co.</i> , 284 U. S. 1	8
<i>West Construction Co. v. Commissioner</i> , 7 T. C. 974	9

Statute:

Internal Revenue Code, Sec. 719 (26 U.S.C. 1940 ed., Sec. 719) ..	7, 12
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Miscellaneous:

Treasury Regulations 109, Sec. 30.719-1	13
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In the Supreme Court of the United States

OCTOBER TERM, 1947

No. 658

THE CANISTER COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES
CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 3a-14a) is reported in 7 T. C. 967. The opinion of the Circuit Court of Appeals (R. 26-31) is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on January 20, 1948 (R. 32). The petition for a writ of certiorari was filed on March 8, 1948. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

(I)

QUESTION PRESENTED

Whether the courts below correctly held that advance payments made by the United States Government to the taxpayer under contracts for the manufacture and delivery of machinery do not constitute borrowed invested capital within the meaning of Section 719(a)(1) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

These are set out in the Appendix, *infra*, pp. 12-15.

STATEMENT

The Tax Court found the following facts (R. 5a-10a):

Taxpayer, a New Jersey corporation, having its office at Phillipsburg, New Jersey, conducts a business made up of two divisions; the designing and manufacture of fiber bodied, custom made containers for packaging dry and liquid products; and the designing and manufacture of automatic machinery for the loading and assembling of ammunition, and of special purpose machinery for commercial use (R. 5a).

Taxpayer keeps its books and reports income on the accrual method of accounting (R. 5a).

On August 7, 1941, taxpayer, as contractor, entered into a written contract with the Government of the United States for the manufacture and delivery by taxpayer to the Navy Department of certain machinery for the loading of ammunition for the total contract price of \$1,866,235. The contract provided for payments of the contract price, and for advances to the contractor to facilitate the performance of the contract, as follows (R. 5a-7a):

ARTICLE 8. Payments.—The contractor shall be paid, upon the submission of properly certified invoices or vouchers, the prices stipulated herein for articles delivered and accepted or services rendered, less de-

ductions, if any, as herein provided. Unless otherwise specified, payments will be made on partial deliveries accepted by the Government when the amount due on such deliveries so warrants; or, when requested by the contractor, payments for accepted partial deliveries shall be made whenever such payments would equal or exceed either \$1,000 or 50 percent of the total amount of the contract.

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ADVANCE UNDER THE AUTHORITY OF THE ACT OF 28 JUNE 1940

The Government agrees to advance to the contractor a sum not to exceed 30 per cent of the contract price,* to facilitate the performance of the contract and the delivery of the automatic loading equipment. The funds required for this purpose will be advanced in one sum or from time to time, as requested by the contractor, provided that an advance shall be made at intervals of not less than fifteen days and only in sums and at times as required to meet payment obligations on these.

The funds advanced will be liquidated by crediting 30 percent of each payment becoming due under the contract to the advance until the full amount of the advance is liquidated.

It is agreed that, in case of default by the contractor in the performance of this contract or the termination thereof, before liquidation of the advance due to causes of contractor's responsibility, the contractor shall refund to the Government upon demand a sum equal to the unliquidated advance, all other provisions of the contract and all rights of the Government to remain in full force and effect.

A bond shall be furnished in a sum equal to 30 percent of the total contract price guaranteeing the accounting for, or repayment, of the sum advanced,

* On the signing of the contract.

provided that in case of default by the contractor in the performance of the contract or any termination thereof before liquidation of the advance due to causes of the contractor's responsibility, the contractor shall refund to the Government upon demand a sum equal to the unliquidated advance, all other provisions of the contract and all rights of the Government to remain in full force and effect; provided, further, that if the principal shall well and truly account for or repay the aforesaid advance payment in accordance with the terms of the contract or any modifications or agreements pertaining thereto that may have been or may subsequently be entered into, notice of such modifications to the surety being hereby waived, then the obligation under the bond to be void, otherwise to remain in full force and virtue.

.

On August 7, 1941, the date of the execution of the contract, the Government advanced to taxpayer \$559,870.50, thirty percent of the contract price of \$1,866,235 (R. 7a).

On August 7, 1941, a "PERFORMANCE BOND," Treasury Form No. 25 (Revised), in the penal sum of \$559,900 was executed by taxpayer as principal and United States Guarantee Company as surety to the Government. The premium charged for the bond was \$4,199.25. The bond recites, *inter alia*, as follows (R. 7a-8a):

The Condition of This Obligation Is Such, that whereas the principal entered into a certain contract, hereto attached, with the Government, dated August 7th, 1941, for

Machinery, 20 Millimeter. am. per contract NOs-86604.

Whereas, provision is made under the contract to advance to the contractor funds in an amount equal to 30 per cent of the total contract price, subject to the stipulation that in case of default by the contractor in the performance of the contract, or any termination

thereof before liquidation of the advance due to causes of contractor's responsibility, the contractor shall refund to the Government, upon demand, a sum equal to the unliquidated advance; provided, further, that in case the material covered by the said Contract Nos-86604 should not be manufactured and delivered by the principal in accordance with the provisions of the contract, and if the principal fails to reimburse the Government in the amount due in the sum or sums paid by the Government to the principal, the surety on the bonds shall be liable to the Government for the amount thereof.

Now therefore, if the principal shall well and truly perform and fulfill all the undertakings, covenants, terms, conditions, and agreements of said contract during the original term of said contract and any extensions thereof that may be granted by the Government, with or without notice to the surety, and during the life of any guaranty required under the contract, and shall also well and truly perform and fulfill all the undertakings, covenants, terms, conditions and agreements of any and all duly authorized modifications of said contract that may hereafter be made, notice of which modifications to the surety being hereby waived, then, this obligation to be void; otherwise to remain in full force and virtue.

.

The contract dated August 7, 1941, called for delivery of goods by taxpayer within 540 days after the date of the contract or order awarded on the bid. Taxpayer did not make any deliveries under this contract during its fiscal year ended April 30, 1942 (R. 8a).

The contract dated August 7, 1941, provided for payment of 90 percent of the contract price of each item upon delivery, as follows (R. 9a):

Ninety percent (90%) of the contract price of each item will be paid upon delivery of each item at its destination for installation. The final ten percent

(10%) will be paid upon completion of installation, satisfactory test and acceptance of each item by the Government, including for the last item delivery by contractor of tracings of drawings, instructions, etc., required by contract specifications.

A supplemental contract was executed by taxpayer and the Government on March 2, 1942, for the manufacture and delivery of additional machinery for the contract price of \$3,654,200. The Government agreed to advance to the contractor funds not to exceed 30 percent of the contract price, under provisions in the agreement which are substantially the same as in the original contract of August 7, 1941; except that sums advanced under the supplemental contract were to be liquidated by crediting 35 percent (instead of 30 percent), of each payment becoming due under the contract to the advance until the full amount of the advance should be liquidated (R. 9a).

On March 2, 1942, the Government advanced \$1,098,260 to taxpayer, which represented 30 percent of \$3,654,200. And on March 2, 1942, taxpayer as principal and certain corporations as sureties, executed an "Advance Payment Bond" in the penal sum of \$1,096,300 (R. 9a),

• • • to save the Government harmless against any and all losses which may result from the failure of the Principal to liquidate or repay to the Government all or any portion of the advance payments so made;

Now therefore, if the advance payments so made are repaid to the Government or are liquidated by deductions from other payments due the Principal, or otherwise, in accordance with the terms of said contract, then this obligation to be void; otherwise to remain in full force and virtue.

The machinery to be delivered under the supplementary contract was to be delivered by taxpayer by February 28, 1943. Taxpayer did not make any deliveries under the

supplementary contract during the fiscal year ended April 30, 1942 (R. 9a-10a).

Taxpayer did not include in its gross income for the fiscal year ended April 30, 1942, any of the sums advanced by the Government under the original and the supplementary contracts; and the Commissioner has not determined that any of such advance payments should have been included in gross income (R. 10a).

The taxpayer treated the advance payments as borrowed invested capital for purposes of computing the excess profits credit (R. 4a). The Commissioner excluded them (R. 4a), and the Tax Court upheld the Commissioner's determination (R. 14a). The Circuit Court of Appeals affirmed (R. 31).

ARGUMENT

Both of the Courts below held, correctly we submit, that the advance payments in question do not constitute borrowed invested capital within the meaning of Section 719(a)(1) of the Internal Revenue Code (Appendix, *infra*). The critical language is that "borrowed capital" is the—

* * * amount of the outstanding indebtedness
* * * of the taxpayer which is evidenced by a bond,
note, bill of exchange, debenture, certificate of indebted-
ness, mortgage, or deed of trust, * * *.

The Tax Court concluded (R. 14a) that the advance payments were payments on account of the contract purchase price, and while they could have taken on the character of sums repayable in the event of the contractor's failure to perform its obligation to make and deliver goods, they were not ordinary loans, and did not give rise to "outstanding indebtedness," as that term is used in Section 719(a)(1). The Tax Court also said (R. 13a) that the Performance or Advance Payment Bond was given to guarantee perform-

ance by the contractor and did not constitute an evidence of indebtedness as required by the statute.

In affirming, the Circuit Court of Appeals said (R. 29) that the Tax Court's conclusion that the advances were prepayments of part of the contract price instead of a loan seemed to be a sensible one which should be allowed to stand under *Commissioner v. Scottish American Co.*, 323 U. S. 119, and *Dobson v. Commissioner*, 320 U. S. 489. It did not rest its decision exclusively on that ground, however, going on to say (R. 30) that, in its opinion, the conclusion of the Tax Court in this regard was supported by substantial evidence and backed by a rational analysis of the transaction.

Moreover, the Circuit Court of Appeals said (R. 30-31) that the decision could also be rested on the ground that a surety bond in the ordinary form such as we have here is not an unconditional promise to pay money and is not evidence of an "outstanding indebtedness" of the taxpayer, but rather is a security bond to protect the Government against a contingent future loss.

The instant decision seems plainly correct on any of these grounds, and it is in harmony with the established rule that the term "indebtedness" implies an unconditional obligation to pay. *Gilman v. Commissioner*, 53 F. (2d) 47, 50 (C. C. A. 8th); *Commissioner v. Park*, 113 F. (2d) 352, 354 (C. C. A. 3d). That is the usual and ordinary meaning of the word, and in the absence of a clear indication to the contrary, it must be assumed that Congress used it in that sense here. - *Deputy v. du Pont*, 308 U. S. 488, 497-498; *United States v. Kirby Lumber Co.*, 284 U. S. 1, 3. It cannot realistically be said that there was any unconditional obligation on the part of the taxpayer to repay the advances. There was no such obligation when the advances were made, and it does not appear that any ever arose. It may be that if the taxpayer had defaulted

in performance, or the contracts had been terminated due to causes of its responsibility, it would have become obligated to make a refund (cf. *Higgins & Co. v. Commissioner*, 4 T. C. 1033, 1043), but no such situation is presented here. It is not enough that the contracts contemplated that the relation of debtor and creditor might arise under some circumstances (see *United States v. Butterworth-Judson Corp.*, 267 U. S. 387, 393), if those circumstances are not shown to have arisen.

In the words of the court in *Enright v. United States*, 54 F. (2d) 182, 188 (C. Cls.), certiorari denied, 286 U. S. 543,

* * * advance payments are not a loan. They are payments of sums that are expected to become due on the contract, and in the ordinary course of events do become due and are applied accordingly.

The instant decision is in harmony with the decision of the Tenth Circuit in *Consolidated Goldacres Co. v. Commissioner*, 165 F. (2d) 542, as well as with other decisions of the Tax Court, such as *Journal Publishing Co. v. Commissioner*, 3 T. C. 518; *Flint Nortown Theatre Co. v. Commissioner*, 4 T. C. 536; *West Construction Co. v. Commissioner*, 7 T. C. 974; and *Gould & Eberhardt, Inc. v. Commissioner*, 9 T. C. 455.

The taxpayer asserts (Pet. 4-7) that the decision below is in conflict with *United States v. Butterworth-Judson Corp.*, 267 U. S. 387; *Powder Co. v. Burkhardt*, 97 U. S. 110; and *Brewster Shirt Corp. v. Commissioner*, 159 F. (2d) 227 (C. C. A. 2d), but we submit that there plainly is no such conflict.

Neither *United States v. Butterworth-Judson Corp.* nor *Powder Co. v. Burkhardt* is a tax case and neither of them is concerned with the statute here involved. Indeed, as

indicated above, the language in the *Butterworth-Judson* case is in harmony with our views, for the Court said (267 U. S. at 393):

It may be assumed that the United States did not retain title to the advance payment, and that when it was made it became the property of the contractor, and also that the contract contemplated that the relation of debtor and creditor might arise.

In *Brewster Shirt Corp. v. Commissioner*, *supra*, the taxpayer had, in effect, mortgaged its receivables to secure a loan, and the court held that this arrangement fell within the statute. Here there is no comparable situation and, hence, no conflict. The care taken by the Circuit Court of Appeals for the Second Circuit to distinguish the factual situation there involved from cases like that at bar is not without significance. See *Consolidated Goldacres Co. v. Commissioner*, 165 F. (2d) at 546 (C. C. A. 10).

The taxpayer urges (Pet. 7-8) that the rule of the *Dobson* case does not preclude review of the Tax Court's decision here. But, even if that be so (*Crane v. Commissioner*, 331 U. S. 1, 15), that court's decision is certainly persuasive and should therefore be accorded considerable weight (*Commissioner v. Estate of Bedford*, 325 U. S. 283, 292; *Bazley v. Commissioner*, 331 U. S. 737, 742). Furthermore, it will be noted that the Circuit Court of Appeals did not confine itself to accepting the decision of the Tax Court under the *Dobson* rule and its opinion, while in essential agreement with the views of the Tax Court, is fundamentally an expression of its own views as well. For the reasons heretofore given, we submit that those views are sound and there is no basis for any further review in this case.

CONCLUSION

The decision is correct; there is no conflict; and the petition should be denied.

Respectfully submitted,

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MARCH, 1948.

APPENDIX

Internal Revenue Code:

SEC. 719 [as added by Sec. 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974]. BORROWED INVESTED CAPITAL.

(a) *Borrowed Capital*.—The borrowed capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following:

(1) The amount of the outstanding indebtedness (not including interest, and not including indebtedness described in section 751 (b) relating to certain exchanges) of the taxpayer which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, plus,

(2) In the case of a taxpayer having a contract (made before the expiration of 30 days after the date of the enactment of the Second Revenue Act of 1940) with a foreign government to furnish articles, materials, or supplies to such foreign government, if such contract provides for advance payment and for repayment by the vendor of any part of such advance payment upon cancellation of the contract by such foreign government, the amount which would be required to be so repaid if cancellation occurred at the beginning of such day, but no amount shall be considered as borrowed capital under this paragraph which has been includible in gross income.

(b) *Borrowed Invested Capital*.—The borrowed invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be an amount equal to 50 per centum of the borrowed capital for such day.

(26 U. S. C. 1940 ed., Sec. 719.)

Treasury Regulations 109, promulgated under the Internal Revenue Code:

SEC. 30.719-1 [as amended by T. D. 5267, 1943 Cum. Bull. 738, 745]. *Borrowed invested capital*.—The borrowed invested capital for any day of the taxable year is 50 percent of the borrowed capital for such day determined as of the beginning of such day. Borrowed capital is defined to mean:

(a) Outstanding indebtedness (other than interest and, in the case of taxable years beginning prior to January 1, 1941, for which the taxpayer has not elected under the provisions of section 230 (d) of the Revenue Act of 1942 to make the provisions of section 760 applicable, other than indebtedness described in section 751 (b) relating to certain exchanges, but including indebtedness assumed or to which the taxpayer's property is subject) of the taxpayer which is evidenced by a bond, a promissory note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, plus

(b) In the case of a corporation having a contract, made before November 8, 1940, with a foreign government to furnish articles, materials, or supplies to such foreign government, amounts received as advance payment in connection with and as provided by such contract, to the extent such amounts would be repayable pursuant to the terms of the contract, if cancellation by such foreign government occurred at the beginning of the day for which the borrowed capital is being ascertained, but no amount shall be included as borrowed capital which has been includible in gross income, plus

• • • • •

In order for any indebtedness to be included in borrowed capital it must be bona fide. It must be one incurred for business reasons and not merely to increase the excess profits credit. If indebtedness of the taxpayer is assumed by another person it ceases to be borrowed capital of the taxpayer. For such purpose

an assumption of indebtedness includes the receipt of property subject to indebtedness.

Whether outstanding certificates designated by such names as "debenture preferred stock" or "guaranteed preferred stock" constitute borrowed capital depends upon whether the holder has a proprietary interest in the corporation or has the rights of a creditor, determined in the light of all the facts. The name borne by the certificate is of little importance. More important attributes to be considered are whether or not there is a maturity date, the source of payment of any "interest" or "dividend" specified in the certificate (whether only out of earnings or out of capital and earnings), rights to enforce payment, and other rights as compared with those of general creditors.

The term "certificate of indebtedness" includes only instruments having the general character of investment securities issued by a corporation as distinguishable from instruments evidencing debts arising in ordinary transactions between individuals. Borrowed capital does not include indebtedness incurred by a bank arising out of the receipt of a deposit and evidenced, for example, by a certificate of deposit, a passbook, a cashier's check, or a certified check.

The provisions of section 719 (a) (2) relating to contracts with a foreign government may be illustrated by the following example:

Example: The X Corporation, which makes its income tax returns on the calendar year basis and reports its income on the accrual basis, entered into a contract with a foreign government on November 1, 1940, for the manufacture and delivery of certain parts for aircraft, and received thereunder an advance payment as of that date of \$500,000. The contract provided for its cancellation by the vendee, and further provided that the advance payment should be returned upon such cancellation less the sum of \$100,000 and \$5,000 for each unit delivered before cancellation. Ten units were delivered December 1, 1940, another 10

units December 30, 1940, and the contract was canceled December 31, 1940, before any other deliveries had been made. Borrowed invested capital would be increased \$200,000 (50 percent of \$400,000) for each day beginning November 2, 1940, and ending December 1, 1940; \$175,000 (50 percent of \$350,000) for each day beginning December 2, 1940, and ending December 30, 1940; and \$150,000 (50 percent of \$300,000) for one day, December 31, 1940.